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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 000533

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SUBJECT: AZERBAIJAN'S BOOMING ENERGY SECTOR HIDES DIFFICULT
BUSINESS OPERATING ENVIRONMENT

REF: (A) BAKU 474 (B) BAKU 505

Classified By: AMBASSADOR ANNE E. DERSE PER REASONS 1.4 (B, D)

11. (C) Summary: Azerbaijan's stunning GDP growth of 34 percent -- fueled largely by the energy sector -- is accompanied by severe corruption and weak rule of law, that since early 2006 appear to be having an increasingly negative impact on firms operating outside the protection of the energy sector's Production Sharing Agreements. The Resident IMF Representative believes that many of the corruption problems stem from an increase in the Customs Service's demands for illegal payments, which is having a ripple effect in both tax collection and the banking sector. Senior business representatives from Azerbaijan's largest foreign investments outside the energy sector report that they also increasingly suffer regular pressure from Government of Azerbaijan (GOAJ) officials -- many of whom have their own significant business interests -- seeking to gain shares in successful businesses at sweetheart rates. The only way to avoid this pressure, the business representatives say, is to avoid taking on local partners, a strategy which also has a negative impact on Azerbaijan's economic development. The negative trends in the business environment in Azerbaijan's non-energy sectors over the last year are a disturbing sign, and make it all the more imperative that the GOAJ take steps now to address the monopolies, corruption and weak rule of law that threaten to strangle the development of its non-energy sectors. End summary.

DIFFICULT BUSINESS ENVIRONMENT

12. (C) With GDP growth of 34 percent in 2006, Azerbaijan has one of the fastest growing economies in the world. On the surface, Baku looks like a capital in the midst of a boom, with construction, expensive European shops, and glitzy restaurants catering to expatriate oil workers and Azerbaijan's business elites mushrooming everywhere. Underlying this veneer, however, is a struggling non-energy sector that is being crippled by official bureaucracy, lack of capacity, corruption and weak rule of law that cloud the investment climate, creating a mean and difficult environment in which to do business. Firms operating outside the protection of the Production Sharing Agreements, which carve out a special transparent, legal and regulatory environment for energy investment, struggle with a lack of rule of law, government accountability and transparency that inhibit investment and overall profits.

13. (C) Discussions with several U.S. and non-U.S. businesses operating in Azerbaijan paint a bleak picture of the difficult business operating environment. As the AmCham laid out candidly for A/S Sullivan and the Economic Partnership

Commission delegation in February, the overall business mood of local businessmen and bankers is dour and reflects growing bearish sentiment for the future, unless the GOAJ takes dramatic action soon. Many businessmen speculate that some government officials, many of whom also have significant commercial interests, are actively seeking to drive out competitors, foreign and domestic, in order to take over key economic markets and sectors therefore serving their personal interests at the expense of broad economic development. Since early 2006, in the view of many international observers, the overall business climate has progressively gotten worse as the level of corruption seemingly has exploded, leading the Managing Director of the Xirdalan Brewery to compare Azerbaijan to Zaire during Mobutu's reign. (COMMENT: This businessmen, who is successfully engaged in a major U.S. investment here, worked in Zaire during Mobutu's reign in the 1990's.)

14. (C) Many private sector businesses and international financial institution contacts, including the Executive Board Chairman of private bank UniBank and the IMF Resident Representative, mark January 2006 as the beginning of a new, worsened phase of government pressures and corruption. In early 2006 Customs officers began demanding larger illegal payments to process goods in and out of Azerbaijan temporarily stopping all imports. During 2006 most companies adapted their practices or used personal and commercial connections to solve customs problems. According to the Chairman of UniBank, Customs officials have also reportedly demanded that businesses underreport the true level of imports, which in turn forces companies to underreport profit and income statements to the Ministry of Taxation. The underreporting of imports also complicates banking and international working relationships for local companies as

BAKU 00000533 002 OF 003

they misrepresent the companies' true well-being.

15. (C) By first quarter 2007, the Embassy's business contacts report that the private sector is beginning to feel the pain of the rising level of corruption. The chairman of UniBank reported to EconOff that many small and medium enterprises have requested renegotiation of terms for current lines of credit and financing, citing their inability to meet repayment terms due to the difficult business environment. In addition, many non-energy sector businesses are putting on hold plans for investment in Azerbaijan due to the uncertainty of the investment climate. One banker told EconOff of a client who has decided to redirect any future investments away from Baku and to Dubai due to the economic and political uncertainties in Azerbaijan. Azerbaijani MP Chingiz Asadullayev, who is proud of his record as an independent businessman, told the Ambassador that increasingly, Azerbaijani business representatives are approaching him as an MP and expressing their frustration and desire for GOAJ action to halt corruption. Several companies shared their individual stories, which follow below.

GARADAGH CEMENT

16. (C) The General Director of Garadagh Cement, a Swiss-owned cement factory in Baku and the largest in Azerbaijan, said that Ministry of Taxes authorities regularly visit his corporate offices to "review the books" looking for tax violations. High-level tax inspectors reportedly offer to stop the tax inspections in return for Garadagh Cement setting them up as cement redistributors with cement provided at favorable rates. Garadagh Cement ran into trouble during the late 1990s and early 2000 when its previous management team engaged in "questionable businesses practices" leading it to be "preyed upon" by several government ministries and agencies. The General Director said that since the new management team arrived several years ago, the company has not engaged in any questionable practices but the Ministry of Taxes and other ministries continue to investigate its

operations. Inspectors from different ministries often pass each other in Garadagh offices, surprised to see one another there, according to Garadagh's General Director.

17. (C) The booming construction sector makes cement a lucrative business. The Prime Minister and Minister of Transportation are reputed to be among the largest cement dealers and mixers in Baku. Azerbaijan's total annual cement market is 2.5 million tons per year with Garadagh Cement making only 1.3 million tons per year. Additional cement is imported from Georgia and Russia. Garadagh's General Director reported that the company is holding off on making large investment upgrades until the business climate is safer and the company's owners believe their investments will not be at risk of nationalization by the GOAJ. In addition, possible investment by the Azerbaijan Investment Company has been delayed due to AIC's veto option on company management (Reftel A). Garadagh is one of Azerbaijan's largest tax payers, with annual turnover of USD 90 million.

BiH EASTERN XIRDALAN BREWERY

18. (C) The President of BiH Eastern holdings, the owner and operator of the local Xirdalan brewery, Jean Paul Lanfranchi, told the Ambassador in a recent meeting that representatives from the Lenkaran governor's office and the Chairman of State Property Management Committee Chief Kerem Hassanov recently approached him and requested 50 percent ownership in the company's vineyard in the southern Azerbaijani town of Jalalibad. The BiH President said he was taken aback at the "brazen approach." He told the Ambassador that he will refuse any attempts by the officials to gain ownership in the vineyard, noting that he planned to raise this issue directly with President Aliyev. He later told the Ambassador that he had raised the issue in a letter to the President and got an immediate telephone call from Minister of Economic Development Heydar Babayev. The Xirdalan brewery is a major U.S. investment in Azerbaijan and one of the country's top ten tax payers and in 2006 produced 250,000 hectoliters of beer. Citibank Venture Capital International Growth Fund owns approximately 92 percent of BiH Eastern holdings.

REAL ESTATE MARKET

19. (C) A local Turkish Cypriot real estate businessman with a British passport recently experienced the harshness of

BAKU 00000533 003 OF 003

operating in Azerbaijan first-hand. A long-time investor in Azerbaijan and owner of several buildings housing international businesses (including BP, ExxonMobil, and some U.S. Embassy offices), this property developer had the construction on his new large office building stopped for more than a month by the Ministry of Emergency Situations on the grounds of a safety review. The stoppage cost USD 15,000 a day in labor costs and millions of dollars in lost rent. He told Econoff that representatives reportedly speaking on behalf of senior GOAJ officials, including Minister of Emergency Situations Heydarov, demanded a controlling stake of more than 50 percent ownership in the new building. The businessman said that when he refused the offer, the Ministry of Emergency Situations, officially closed down the construction site. In the end, the businessman negotiated a settlement that included selling some ownership in the new building. Construction on the building complex has since resumed.

BUSINESS BEST PRACTICES

110. (C) From various discussions, it would appear that one of the safest ways to operate in Azerbaijan is to never give in to official or non-official corruption no matter what the short-term gains. In the long-term, the "system" will cease

harassing the company, understanding that nothing can be done. The Managing Director of the McDonald's chain in Azerbaijan told the Ambassador that since he is a U.S. company he has never given a bribe to facilitate the importation of goods or the location of a new McDonald's site. In addition, he pre-pays his quarterly tax revenue to the Ministry of Taxes. Since he operates only in the official sector, he has had less problems than other businesses even if he has "sacrificed short-term financial gains." He opined that once a company gives in to the corrupt official or office, it is impossible to reverse course and correct the situation. The vicious cycle spirals out of control as the illegal demands increase exponentially.

The McDonald's Managing Director highlighted the importance of businesses paying all legal and published taxes and customs duties. An executive at Turkish-owned Ramstore strongly reiterated this theme of never giving in to corruption and paying all published taxes and duties.

¶11. (C) The President of BiH Eastern and Xirdalan brewery also shared this view, stating that in order to operate in Azerbaijan it was important never to pay bribes, pay all taxes and never get "too big." If a business becomes too big, too successful, he said it will attract "sharks" that will come to take a piece of the business. He indicated that the operating environment in Georgia was equally difficult, noting that his brewery there has had problems with government officials who own a competing brewery.

COMMENT

¶12. (C) The long-term success of Azerbaijan depends upon the development of the non-oil private sector to promote economic growth and employment. With energy resource exports set to decline by 2015-2020, the GOAJ will need a sound foundation for broad based sustainable growth to ensure economic and political stability. Continued economic and political reform -- particularly changes that strengthen rule of law -- are essential to attract foreign and domestic investment outside the energy sector. The GOAJ's recent statements regarding accession to the World Trade Organization are positive, as the WTO accession process could help facilitate the legal and regulatory changes needed to establish a transparent, market-oriented economy. In addition, on May 1 President Aliyev ordered several key ministries to review their procedures and present recommendations on how to improve the business operating environment. With inflation and some of the distorting effects of Azerbaijan's energy-based growth beginning to kick in (Reftel B), time is of the essence. Azerbaijan's successful economic reform and sustainable development is key to the country's stability and therefore important to U.S. interests; absent reform, Azerbaijan stands a real chance of becoming a failed petro-state, north of Iran, south of Russia and sitting on a key transit route for Caspian energy resources to the West. In our own interests, it is essential that we continue to engage in all areas of our political and economic reform agenda, to promote Azerbaijan's sustainable development and transition to a market-oriented democracy.

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